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Mr. David S. Guzy
Chief, Rules and Publications Staff
U.S. Department of the Interior
Minerals Management Service
Royalty Management Program
Rules and Publications Staff, MS 3021
Building 85, Denver Federal Center, Room A-212
Denver, Colorado 80225-0165

Re: *Proposed Rule for Establishing Oil Value for Royalty Due on Indian Leases*

Dear Mr. Guzy:

Texaco Inc., on behalf of itself and its affiliates, including Texaco Exploration and Production Inc. ("TEPI") and Four Star Oil & Gas Company, appreciates the opportunity to submit these preliminary comments on the Proposed Rule for Establishing Oil Value for Royalty Due on Indian Leases that was published in the Federal Register on February 12, 1998 (63 Fed. Reg. 7089). These comments are necessarily preliminary because the published Notice and public record supporting the proposed rule have virtually no explanation or basis for its promulgation. Consequently, we have not had the opportunity to evaluate fully the basis for and impact of the proposal, which would radically alter valuation methods for crude oil produced from Indian leases. At this stage, however, two things appear certain: (1) the proposed rule, if implemented, would harm Texaco's and its affiliates' businesses, resulting in the loss of efficiencies we create as an integrated Indian lessee; and (2) the proposed rule fails to meet its stated objective of adding more certainty to valuation of Indian lease production. We urge MMS to withdraw the proposed rule, and not to abandon the long-standing principle of valuing crude oil at the lease using arm's-length sales and purchase prices in the field of production. Texaco and its affiliates have worked closely with MMS in past rulemaking efforts and very much hope to continue to do so. We stand ready to assist MMS in clarifying and improving methods to continue to ascertain that prices in the field are arm's-length and, thus, fairly reflect supply and demand conditions in the field.

The proposed rule abandons the use of arm's-length sales and purchase prices in the producing field, as required by law, and would create artificial royalty values based on prices that are not tied to fair market values in the field. Indeed, as discussed herein, the proposed valuation methods and formulae would create a wide disparity of potential crude oil values at the lease. Crude oil of the same type produced in the same field on the same day could have innumerable different, artificial values depending on where and how it is transported and whether or not the lessee is integrated. We oppose this and any proposal that unfairly and unlawfully moves valuation away from the lease and discriminates against the integrated producer.

The proposed rule effectively raises the royalty rate of Texaco's Indian leases. The proposal would simply boost Indian royalty receipts by valuing crude oil as if it were already located in markets far away from the lease, and would then severely limit the cost adjustments allowed back to the lease. Current Indian lease terms, based on years of consistent interpretation and case law, require crude oil to be valued at the lease for royalty purposes. Application of the proposed rule would unilaterally and unlawfully change the royalty terms in existing Indian crude oil leases, and, thus, in effect, rewrite the lessor's basic contractual obligations. In similar instances where the government has sought to abrogate the essential bargain of its contracts, the Supreme Court has declared such abrogations impermissible.

Attached hereto and incorporated into these comments are reports of four experts addressing issues that appear to have been raised by consultants interviewed by MMS in formulating the proposed rule and in formulating the proposed valuation rule for Federal leases that was published in January 1997. Again, we are prejudiced in not having access to details of the MMS consultants' conclusions or data backing them up. The experts whose reports are attached are as follows:

1) Dr. Philip K. Verleger, Jr., an economist and former Director, Office of Domestic Energy Policy, U.S. Treasury Dept., comments that the proposed New York Mercantile Exchange (NYMEX) index is a flawed and unreliable indicator for all types of crude oil prices at the time and place of production and would lead to substantial valuation errors (Tab 1);

2) Dr. Benjamin Klein, Professor of Economics at UCLA, comments that the netback formulae under the proposed rule are a "convoluted and arbitrary procedure which is certain to produce large errors" (Tab 2);

3) Samuel A. Van Vactor, President of Economic Insight, Inc., comments on the uncertainty, additional administrative cost, and valuation errors that would be created by the proposed formula-based pricing (Tab 3); and

4) Robert B. Bossung, of Solomon Associates, Inc., presents an illustration of the high level of arm's-length crude oil transactions in the producing fields in Texas as an example (Tab 4)

In contrast to the comments of these experts, the public record lacks evidence supporting the proposed rule or demonstrating that the proposed valuation methods and formulae could possibly work. Moreover, MMS has failed to consider other, more accurate and less burdensome alternatives for valuing Indian lease production, such as Texaco's tendering program and taking Indian royalty oil in kind.

I. INDIAN LEASES REQUIRE CRUDE OIL TO BE VALUED AT THE LEASE FOR ROYALTY PURPOSES

Texaco's Indian leases, some of which have been in existence for more than seventy-five years, generally provide for royalties to be paid on the basis of a stated percentage "of the gross proceeds of all crude oil *extracted from the said land*" (*e.g.*, Oil and Gas Mining Lease -- Allotted Indian Land, ¶ 2 (Mar. 13, 1912)(emphasis added)), or on the basis of a stated percentage of "the value or amount of all oil . . . *produced and saved from the land leased herein* . . ." (*e.g.*, Form 5-154h, ¶ 3(c) (Jan. 1962)(emphasis added)). In addition, many of Texaco's more modern Indian leases contain a "major portion" provision, which requires that royalties be paid based on the higher of (1) the gross proceeds of the crude oil produced and saved from the leased land, or (2) the highest price paid for a major portion of the crude oil *produced from the same field.*

The proposed rule would unilaterally change these essential terms of Texaco's Indian leases, because the rule would not measure the value of crude oil produced and saved from the leased land, or calculate the price at which the major portion of crude oil produced from the same field is sold. Indian crude oil leases are legally binding *contracts* and the parties thereto are entitled to rely on their terms. The government, as trustee for the Indian lands, is bound by the terms of the crude oil leases. *C.f., Rosebud Coal Sales Co. v. Andrus*, 667 F.2d 949 (10th Cir. 1982) (applying standard contract law to federal oil and gas lease transactions).

Texaco has vested contractual rights in its Indian oil and gas leases. *See e.g., Enron Oil & Gas Co. v. Lujan*, 978 F.2d 212, 214 n.2 (5th Cir. 1992) ("Oil and gas leases are 'both conveyances and contracts.' . . . The method by which royalty is to be calculated is a contractual provision.") *cert. denied*, 510 U.S. 813 (1993); *see also Standard Oil Co. v. Hickel*, 317 F. Supp. 1192, 1197 (D. Alaska 1970) ("The Government's rights and obligations as lessor of public lands are no different from those of any other lessor."), *aff'd,* 450 F.2d 493 (9th Cir. 1971). Any attempt by MMS to apply the proposed rule to determine royalty valuation would be a material breach of the lease provisions.

The proposed rule states, at section 206.50(a), that a provision of the proposed rule would not apply if it is inconsistent with "[a]n express provision of an oil and gas lease subject to this subpart." It follows, therefore, that because the proposed rule is inconsistent with Texaco's existing Indian leases, it cannot be applied to Texaco.

II. THE PROPOSED RULE FAILS TO MEASURE MARKET VALUE AT THE LEASE AND THEREFORE BREACHES ESSENTIAL TERMS OF INDIAN LEASE AGREEMENTS

A. The Best Indicators of Market Value of Production at the Lease are Arm's-Length Purchases and Sales of Crude Oil in the Producing Field

The most reliable measures of market value at the lease are arm's-length purchases and sales of crude oil in the producing field. *See* Comments of Prof. Joseph P. Kalt, submitted in response to January 1997 *Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases*, at 6 (May 27, 1997); *see also Shamrock Oil & Gas Corp. v. Coffee*, 140 F.2d 409, 410 (5th Cir.)(holding that to determine "market price" the court must look to "the price that is actually paid by buyers for the same commodity in the same market"), *cert. denied*, 323 U.S. 737 (1994); *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 240 (5th Cir. 1984)(the "best means of determining the market value at the well . . . would be to examine comparable sales"), *cert. denied*, 471 U.S. 1005 (1985); *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996)("Market value is the price a willing seller obtains from a willing buyer"). The negotiated price for a specific lease reflects a wide variety of supply and demand factors relevant to the marketing conditions at the time of negotiations.

A substantial bidding market exists at the lease level. TEPI is only one of many companies selling crude oil to third parties in the producing fields. Texaco Trading and Transportation Inc. (now part of Equilon Enterprises, L.L.C., a joint venture of Texaco Inc. and Shell Oil Company), for example, purchased 200,000 barrels per day of crude oil from third parties at the lease in 1996. Leading crude oil marketers such as Scurlock Permian Corporation introduced evidence into the administrative record in response to the proposed Federal oil valuation rule that fierce competition for the purchase of crude oil exists in virtually every major field in the United States. (Transcript of MMS Hearing in Houston, Tx., April 17, 1997.)

By way of example, since the State of Texas maintains such records, we asked the firm of Soloman Associates, Inc. to review "First Purchaser" forms filled out by Texas crude oil lessees. These records show a "highly active, competitive market for crude oil at the lease." (Bossung Report at p.1) For just one representative month, December 1995, a conservative estimate showed 11,236 out of 12,227 entries (91.9%) involved arm's-length transactions at the lease level in Texas. (*Id.* at p. 5.)[1] Of course, any time MMS or an Indian lessor might be concerned that competition is lacking at any particular lease, the lessor can take its royalties in kind and further enhance the competition.

1 In addition to these many private company arm's-length transactions, the State of Texas, both through its General Land Office as well as the University of Texas Lands System, separately sells significant volumes of crude oil as part of its royalty in-kind program.

Instead of using arm's-length purchases and sales of crude oil in the producing field to value Indian lease production, the proposed rule would require Indian lessees to initially determine the value of Indian lease oil using the highest of the following two valuation methods: (1) the average of the five highest daily NYMEX futures settle prices, at Cushing, Oklahoma, for the Domestic Sweet crude oil contract for the prompt month, and (2) the downstream, resale gross proceeds received for the lease production (or oil received in exchange for lease production) that is sold under an arm's-length contract. (63 Fed. Reg. at 7100.) Within 120 days after the lessee's "initial" royalty valuation, MMS would, under the proposed rule, calculate a "major portion value" for each of the MMS-published "designated areas." (*Id.*) If the MMS-calculated "major portion value" exceeds the lessee's initial royalty valuation, the lessee would be required to revise its initial royalty valuation and pay royalties based on the MMS-calculated "major portion value." (*Id.*) As discussed below, neither the NYMEX futures settle prices nor downstream "gross proceeds" is an appropriate benchmark to value crude oil in a producing field. Moreover, the proposed "major portion value" is not only an inappropriate benchmark, but conflicts with the "major portion" provision of Indian leases.

B. The NYMEX Futures Market is Not an Appropriate Benchmark to Value Crude Oil in a Producing Field

Under proposed section 206.52(a), Indian lessees would be required initially to compute royalty value using "the average of the five highest daily NYMEX futures settle prices (Cushing, Oklahoma) for the Domestic Sweet crude oil contract for the prompt month." (63 Fed. Reg. at 7100.) Hence, the proposed rule uses the NYMEX futures value of West Texas Intermediate ("WTI") in the trading pit to value every type of crude oil in every Indian oil field. This *future* NYMEX price is used as the *current* value for crude production at the lease despite major gaps in timing, location and quality between the NYMEX trading floor and the point of primary supply at or near the wellhead location.[2] In fact, supply and demand factors are usually substantially different between these points.

The NYMEX futures market is very different from the lease markets. For example, a NYMEX official testifying at MMS's hearing in Houston on the proposed Federal oil valuation rule acknowledged that NYMEX has never researched correlations between "the lease and *our market*." (Transcript of MMS Hearing in Houston, Tx., April 17, 1997, at 192.) The NYMEX is a paper market, not a "wet barrel" market. Participants in the NYMEX buy and sell futures

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2 MMS proposes to use the prompt NYMEX month in effect on the first day of the production month and would track those prices for a twenty-eight to thirty-one day period prior to expiration around the 21st of the month. For example, values for crude oil to be physically delivered in April 1997 would be pegged to the average of the five highest daily NYMEX prices for the May delivery contract as traded between March 21st and April 20th. Regardless of seasonal variations and numerous other factors, the proposal applies a futures, or speculative price to the current value of oil.

contracts rather than actual barrels of oil -- almost exclusively to hedge or speculate. NYMEX is a market for "risk trading" and not oil trading. NYMEX transactions neither measure prices "at the lease" nor prices at the time of production.

As set forth in the attached report of Dr. Philip K. Verleger, Jr., the daily closing price on the NYMEX, which reflects the last two minutes of a trading day, is not a reasonable proxy for the value at the lease at the time of production of even WTI, let alone the numerous other crude oil grades throughout the Indian land mass. On average, there is less than .003 percent physical deliveries in any one month on a NYMEX contract, as compared to 75,000-150,000 contracts traded daily (an equivalent of 75-150 million barrels per day). Trading in such paper barrels relates exclusively to bulk markets, whereas production at the lease is often in small quantities, with unique quality, logistical and local market considerations that can be very different from the NYMEX paper barrel. Seventy-five percent of U.S. crude oil wells are stripper wells, which produce on average only 2.1 barrels per day.

MMS ignores price fluctuations in intra-day trading on the NYMEX. MMS proposes using the "settle" price, which is computed from transactions that occur during the last two minutes of trading each day. (Verleger Report at pp. 1-2.) Trading in NYMEX contracts regularly occurs during 21 hours and 25 minutes of each business day. (*Id.*, at 2.) There are between 19 and 23 business days in any given month. Accordingly, NYMEX trades occur between 407 and 492 hours each month. However, MMS proposes to use trades for royalty valuation purposes that occur in only *10 minutes* out of the 407 to 492 *hours* in which the market is open. Viewed differently, a spot contract trading for twenty days out of a month would trade for 424.32 hours. *(Id.)* Yet, under the MMS proposed formula, only 0.17 hours of this trading period (less than 0.0004 percent of total trading time) would be sampled in the determination of settlement prices. No consideration would be given to the weighted average sales price in the NYMEX trading pit, which reflects volumes traded as well as price fluctuations during the trading day. (*Id.*)

NYMEX values are also influenced by speculation about future price conditions that may have no relationship to a particular lease. (*Id.* at 3-9.) Dr. Verleger emphasizes that speculation contributes to a "risk premium" in NYMEX trading that appears especially prevalent in crude futures trading. (*Id.*). In addition, NYMEX values are necessarily influenced by pipeline delivery constraints at Cushing, Oklahoma. "Squeeze" situations by traders, and participation by commodity hedge funds and other non-commercial entities, create unique supply and demand conditions. For example, a bottleneck in certain pipeline deliveries to Cushing would create high prices at the Cushing end of the pipeline and correspondingly low prices at the opposite end of the pipeline, i.e., the field. *(See id.* at 9-10.) The influences of such a bottleneck on the Cushing price would necessarily have an opposite effect on valuation at the leases served by the pipeline. *(Id.)*

NYMEX closing values, particularly in the last few days of the expiration of the prompt contract month, are susceptible to manipulation due to options strike prices and the opportunity for options traders to benefit from premiums on the strike prices. (*Id.* at 10-12.)

The MMS proposed rule rests on many assumptions, some expressed and some implied, for which much of the underlying factual information has not been disclosed to the public. For example, the Notice to the proposed rule alludes to "a number of presentations by: crude oil brokers and refiners, commercial oil pricing reporting services, companies that market crude oil directly, and private consultants knowledgeable in crude oil marketing." (63 Fed. Reg. at 7090.) MMS has not made this information available, other than providing cursory overviews of the consultants' opinions. Virtually no evidence has been inserted into the public record backing up these opinions. As best we can tell, MMS is basically relying on the litigation-driven opinions of consultants working for plaintiffs' lawyers that have been and remain involved in lawsuits against Texaco and other producers and buyers. Such views can hardly be viewed as objective or dispassionate and should not be used as the basis for regulatory action.

The consultants' opinions relied upon by MMS in preparation of its NYMEX index proposal have successfully been challenged in litigation against Texaco and others. Recently, for example, a New Mexico state court heard the testimony of Benjamin Johnson of Summit Resources in support of plaintiffs' motion to certify a class of royalty owners, which the court rejected. *Engwall v. Amerada Hess,* No. CV-95-322 (N.M. 5th Jud. Dist. Mar. 26, 1997). MMS has identified Mr. Johnson as a consultant. In the *Engwall* case, Mr. Johnson testified that he had recommended to MMS that only as a *last resort* should market values of crude oil in the producing fields be calculated using a net-back formula based on NYMEX prices. (Tr. at 347-48, attached at Tab 5.) Mr. Johnson testified that he had recommended to MMS that if oil companies sell crude oil either "outright in an arm's-length final sale with no other consideration," or if the companies enter into a "buy-sell transaction" where "oil was exchanged for oil at another location," then such transactions should be used for royalty valuation purposes. (*Id.*) Mr. Johnson testified that his recommendation to MMS was that "[i]f we didn't have *any* of those actual transactions . . . then we can *use a comparable analysis* to look at other *nearby locations* whereby we look at buy-sell transactions that were employed by the defendants or by other companies of similar sophistication." (*Id.* at 348 (emphasis added).) According to Mr. Johnson, his recommendation to MMS was that only if *none* of these arm's-length transactions exist, then as a last resort, should a net-back methodology be attempted:

> Then the final method is, if there are none of those, if there are *no [outright sales or] buy-sell transactions available*, then *the last* would be a methodology, a net-back type methodology to be administered by the Minerals Management Service.

(*Id.* (emphasis added).)

The court heard contrary testimony of a widely-noted Harvard University economist, Dr. Joseph P. Kalt, who had compiled a vast database of arm's-length crude oil transactions in the producing fields in a number of states. Dr. Kalt demonstrated that a substantial variability exists among specific supply and demand factors from lease-to-lease and transaction-to-transaction. (Tr. Vol. 5 at 1143, attached at Tab 6)("[I]f you look at data on actual arm's-length comparable transactions, you do indeed find that those transactions at the lease demonstrate the influence of *highly-localized supply and demand factors, and in a quite substantial way*.") Dr. Kalt concluded that "[w]hen you look at how the market speaks at the field level, market valuation of actual transactions varies significantly with supply and demand factors specific to particular leases, crude oils, and transactions." (*Id.* at 1144.) Dr. Kalt specifically rejected Mr. Johnson's net-back theories, noting that they cannot account for variability at the lease. (*Id.* at 1180-94.) Buyers at the lease level must account for such factors as transportation costs, storage availability, and costs of developing information regarding customer demand for various types of crude oil, and assumption and management of risk. Dr. Kalt noted that moving crude oil from the field to a market center is a "highly risky business." (*Id.* at 1183.) Dr. Kalt described the supply and demand factors involved in the NYMEX trading pit as "noncomparable to those in the field." (*Id.* at 1188.) Even comparing major trade centers such as Midland, Texas and Cushing, Oklahoma, Dr. Kalt determined that "the reasonable conclusion to be drawn is that even at trade centers, one sees different localized supply and demand factors that are specific to that trade center and make it different from the [other] trade center, and based on my evidence, also different from the supply and demand factors that one sees operative at the lease." (*Id.* at 1192.) Thus, Dr. Kalt testified that the NYMEX "demonstratively reflect[s] different supply and demand forces." (*Id.* at 1194.) Dr. Kalt concluded that "[t]hose forces are not present in the lease, they are not the same ones that are present at the lease in their totality, and as a result, there is an arbitrariness in the selection of these values." (*Id.*)

C. Downstream Resale Price is Not an Appropriate Benchmark to Value Crude Oil in a Producing Field

For many of the same reasons that using NYMEX futures pricing is inappropriate for valuing crude oil in a producing field, affiliates' downstream sales are also an inappropriate benchmark. Each producing field has unique characteristics. They range from crude quality to logistical factors. Crude oil fields are subject to widely divergent economic influences depending on such factors as the quality of the crude, the supply and demand for different types of crude and the capabilities of local refiners in each region, the distance from the field to potential buyers, and the transportation alternatives available from each field. (*See* Report of Dr. Benjamin Klein, attached, at p. 5.) For example, if delivered by truck, road conditions and hauling distances to an intermediate storage point must be considered. If pipeline gathered, factors of physical line conditions and overall capacities at both intermediate and final sales points must be considered. Some crudes, such as relatively light, low sulfur crudes, can be processed economically by a large number of different refiners. Others, such as very heavy crudes or crudes with high sulfur levels, are most economically processed by refineries with specialized refining equipment such as cokers, catalytic crackers, and hydrotreating facilities that can upgrade the crude into light products such as gasoline. (*Id.* at p. 6.) Consequently, as Dr. Klein explained, it is generally "very difficult to value correctly crude oil in the field based on prices of transactions that occur downstream." (Klein Report, at 15).

The oil sold downstream is generally commingled and therefore not the same oil purchased at the lease; the market in which the oil is sold is very different from the market at the lease; and the affiliates' sales prices include the value of midstream transportation and storage assets and downstream marketing services, as well as the cost of assuming a significant amount of risk. Unless the "net-back" methodology properly adjusts for all of these differences, and considers the full value added by all downstream operations, it cannot reliably measure the value of the crude in the field. The proposed "net-back" methodology fails to adjust even for quality differences, and fails to subtract the full value added by downstream operations. As a result, the proposed use of resale gross proceeds will consistently, and significantly, overstate the value of the crude in the field. (*Id.*)

D. The Adjustments and Allowances Set Forth in the Proposed Rule Do Not Correct the Rule's Deficiencies

1. Spot Price Adjustments Cannot be Used to Equate Crude Oil Lease Production to NYMEX Values

MMS has consistently condemned the use of either spot or futures price benchmarks netted back to the lease as a reliable indicator of production values. For example, MMS's Associate Director was highly critical of using such benchmarks in a memorandum concerning adoption of the 1988 regulations:

> Application of spot prices in valuing non-arm's-length disposals of lease production would not be specific. Spot prices are available only for a limited number of "benchmark" domestic crudes delivered at specific points; *e.g.*, West Texas Intermediate at Cushing, Oklahoma. It is not clear how spot prices would be adjusted for differences in quality or necessary transportation between that of the "benchmark" crude and that of the crude to be valued. An adjustment for differences in API gravity alone, for example, while a reasonable price adjustment mechanism for oil produced in the same field or area, does not necessarily reflect true value differences when comparing crudes from distant areas. The price differences in crude oil nationwide depend upon a host of factors not limited solely to gravity and transportation adjustments. Factors important to the establishment of value of a particular crude include the need for an availability of crude oil supply, the cost of transportation to the refinery, the chemical compositioning characteristics of the crude oil, the cost to refine the particular crude, the mix of refined products derivable from the crude and their values, prices currently paid or offered for the same or comparable crudes, and other economic criteria. Posted prices, which exist in all the important producing areas,

> reflect all these considerations; "benchmark" spot prices on the other hand, cannot relate these factors specifically to each producing area. The same is true for futures prices, which also relate to a few "benchmark" crudes only.

(Memorandum from Associate Director for Royalty Management to Director, MMS, Feb. 12, 1987.) Nevertheless, MMS proposes to adjust the flawed NYMEX *futures* index using *spot prices*.

Published crude oil spot prices, such as Platts assessments East of the Rockies cover only the following grades: WTI at Cushing, Oklahoma and Midland, Texas; West Texas Sour at Midland; Light Louisiana Sweet at St. James, Louisiana; Eugene Island Sour at St. James; Louisiana Heavy Sweet at Empire; and Wyoming Sweet at Guernsey, Wyoming. Yet, unlike circumstances, for example, in natural gas markets, there are dozens of other grades of crude oil produced East of the Rockies. Many of these crude oil grades have substantially different physical and market characteristics from the Platts spot price assessments, and cannot equitably be equated to those spot price values. Crude oil spot markets are less mature than, for example, natural gas spot markets, and a much smaller percentage of crude production is traded in spot markets as compared to natural gas. Ironically, however, MMS rejected the use of index pricing for valuing natural gas, yet proposes to use index pricing for valuing Indian oil.

Platts does not report volumes on the various spot assessments, and strong doubt exists about certain of the reported grades. For example, presently, arm's-length spot market transactions in Guernsey of Wyoming Sweet crude oil more often than not differ significantly from Platts reported spot prices.

Platts also does not divulge its method of obtaining market assessments other than to state they are for one-hour time windows in the afternoon using telephone polling of selected people in the "industry." Of course, such people might be selective in the data they provide. Therefore, assessment values are subject to distortion and, perhaps, manipulation. In addition, since transactions occur between parties over a 24-hour period, the one-hour window of time used by Platts may not be a reasonable indicator, particularly if a crude grade is thinly traded and market prices are changing. It is hard to believe how any such mechanism could be used to provide actual, reliable pricing information.

In addition, as discussed in greater detail below, any attempt by MMS to collect information and publish its own differentials to account for the inadequacy of the spot price publications could not provide sufficiently current data to account for changing market conditions. Again, the relative spreads among different grades/qualities of crude oil and among different production areas can change rapidly. MMS's data collection methods would yield obsolete data before they could be processed and published.

The fact that contracting parties might sometimes use a price basis such as a Platts spot price or a NYMEX futures price in crude oil sales contracts to arrive at a price at the lease is not evidence that such prices could or should be mandated as values for all Indian lease crude oil production, or for the same lease production regardless of changing circumstances. Parties who use a price basis for specific sales understand the risks and circumstances involved at the time they are doing so. The same parties contracting a month later at the same lease might choose a much different price mechanism. But in either case, the current arm's-length price should be accepted for royalty value regardless of how that price may be derived.

In addition, MMS purports to introduce "certainty" to royalty valuation through a process that, in part, involves simple averaging of spot prices at Cushing, Oklahoma across each month. Such an arithmetic averaging method could distort actual market conditions in the valuation process. For example, the proposed valuation assumes equal weighting of spot prices for each day of the month. However, transaction volumes across any given month are uneven and prices observed on different days may not have the same meaning. For example, if a spot transaction were to occur at a particular location for a particular quality of crude only one day per week on average, the spot price observed on that day could only reflect the supply and demand conditions at that location on that day. Yet, prices on days when no spot transactions occur may be substantially different from those on the day of the recorded transaction. The MMS methodology thus would not reflect any changes in market conditions that have occurred since the last transaction. Averaging spot prices across all days (*i.e.*, giving equal weight to days when many transactions occur and days when only one occurs) would distort the market value of crude. This becomes particularly problematic given that spot market activity, especially near Cushing, during any given month may be most concentrated in days leading up to the expiration of futures contracts. Of course, averaging spot prices over a month under the MMS methodology would do nothing to reduce the distortion induced by low or uneven transaction volumes. In addition, the spot prices would not be volume weighted. Thus, prices for very low volume contracts would have the same impact on the MMS value as prices for large volume contracts.[3] The MMS methodology also fails to account for the fact that spot prices listed in one publication may be different from spot prices in another publication.

At any given time, buyers might have unique needs for incremental spot supplies of crude oil having certain characteristics. For example, a refinery whose water-borne cargo is delayed several days might enter the spot market and pay a premium significantly in excess of the average price of crude oil. MMS's averaging concept ignores the distributional consequences resulting from such unique supply and demand needs among buyers and sellers. In addition, under MMS's proposal, the lessee who enjoys an above-average price would pay a lower royalty, whereas a competing lessee who sells oil below the average market price must pay a higher royalty. Such a result not only distorts market efficiencies but is inequitable and, frankly, without legal basis.

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[3] MMS could not use a weighted average under its methodology because transaction volumes are not available from published sources.

2. The Proposed MMS-Published Location/Quality Differentials Would Be Based On Irrelevant Information

Incredibly, MMS would also use year old, irrelevant information to adjust NYMEX futures prices to account for vast distinctions among qualities and locations of Indian crude oil production. Understandably, MMS presents no evidence that such adjustments would properly capture the location/quality differentials in the marketplace at the time of production. The proposed rule states that MMS would publish on an annual basis a set of location/quality differentials between each "designated area" and its associated market center based on information provided by lessees in proposed Form MMS 4416, "Indian Crude Oil Valuation Report." The five market centers proposed by MMS bear little or no relationship to the actual disposition of Indian crude. Moreover, MMS lacks authority to require Indian lessees, much less their affiliates and other non-lessees, to supply information in connection with transactions involving non-Indian leases. Even if such authority existed, the proposed information would be obsolete and meaningless by the time it could be processed and published. It would certainly become obsolete and irrelevant over the course of a year. The concept of using historic buy/sell, exchange, and sales contract data ignores completely the dynamics of the marketplace, where the relative spread in prices among various crude grades as compared to WTI, for example, changes frequently. (*See e.g.*, Van Vactor Report at 7-9; Klein Report at 9-11.) The proposal ignores issues of supply and demand seasonality and changing logistical constraints applicable from one field to the next. Thus, an increase or decrease in pipeline capacity, refining capacity, or production volumes, or even changes in the weather, could have a substantial impact on either location or quality differentials that would not be reflected in last year's differentials.

In addition, the variety of types of buy-sell, exchange, and sales transactions and the multiple competitive factors affecting any one such transaction would make it impossible for MMS to develop a meaningful differential, even if the information were current. Any adjustments MMS might allow to account for such factors as location, gravity, sulfur content, blending costs, transportation costs and other factors would necessarily be arbitrary. For example, quantities or qualities of crude oil being exchanged may not be equal. The timing may not be equal. An exchange may be a term transaction or a spot transaction. Yet, MMS proposes to combine somehow (apparently by ignoring these issues) the data derived from proposed Form 4416 in order to derive a single *annual* quality/location differential between each designated area and its associated market center.

In addition, some designated areas may have very few buy/sell or exchange transactions. Such limited transactions would be used by MMS to reflect market differentials for an entire year. Given rapidly changing market conditions over the course of a year, such small samples of potentially varied transactions would be statistically invalid for purposes of providing any average differential.

In sum, requiring Indian lessees to base royalty payments on a prior year's location/quality differentials, which would have no relationship to current market conditions, is unreasonable, unlawful and terrible policy, and would impose unnecessary, substantial new risks on the lessees.

3. The Proposed Allowances and Adjustments Fail to Consider the Value Added by Midstream and Downstream Assets and Services

The proposed allowances and adjustments to both the NYMEX index pricing and affiliates' downstream resale gross proceeds fail to consider the value added by midstream and downstream assets and services. For example, the proposed rule would fail to provide an allowance for such midstream services as the aggregation of small, diverse lease volumes into pools of oil suitable for a distant sales point.[4] To market crude oil away from the lease, such companies must maintain costly storage facilities and an inventory of crude oil in many locations, both in tanks and in the substantial pipeline fill needed to ship crude oil via pipelines. Such companies also provide substantial off-lease marketing services, as distinguished from marketing services at the lease level.[5] Marketing personnel must be experts in analyzing supply and demand conditions. Other personnel must manage inventories, plan deliveries, assess storage availability and costs, and provide accounting and administrative back-up. Administrative services alone include scheduling the movement of crude, measuring and determining the quality of the oil, providing various accounting services, managing accounts receivable and assessing/managing the credit risks and commercial exposure in holding inventories. Not only are the costs of such services ignored by the MMS proposal, but the service provider is not permitted an economic return on the required investment, or compensation for the exposure to risks. The value of these services is completely ignored by the proposed rule and would thus be added to crude oil values *at the lease.*

In addition, crude oil values away from the lease reflect substantial risks incurred in moving crude to various markets. No cost adjustment would be allowed for such risks under the proposed rule. Equilon, for example, assumes environmental risks including risks of oil spills in transit and at storage facilities, risks of delays resulting from such factors as equipment failure or weather, the risk of price volatility between the date of production and date of resale, risks of line loss (*i.e.*, unaccounted for volume shrinkage), credit risks inherent in reselling oil to third parties, unforeseen delivery bottlenecks and breakdowns in planning, and numerous other economic risks.

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[4] The value added by aggregating large volumes of crude oil is obvious. A buyer is usually willing to pay more if it can avoid the cost of contracting with many different suppliers for a desired volume of oil.

[5] MMS appears to assume that lessees have a "duty" to provide such downstream marketing services at no cost. As discussed herein, this assumption directly contradicts lease provisions and is contrary to law. It is a unilateral taking of the increase in value derived from the many services provided off the lease.

The proposal effectively grabs values added by commercial participants as the oil moves from the lease to the end-user. Under the MMS rationale, the lease buyer, the gatherer, the trader, the market analyst, the broker and every other midstream commercial player should not recoup the value of their services. The MMS proposed approach effectively means there is no localized lease level value for crude oil, and no difference between spot and long term contract prices. Actual transactions in the field have no merit as a valuation benchmark under MMS's proposal, while the standard becomes the distant commodity trading in the NYMEX pit or the downstream, market center gross proceeds. MMS ignores countless arm's-length transactions *in the producing fields* that create a viable and working cash market, involving a broad array of industry participants. These transactions necessarily reflect local conditions at the lease.[6]

In addition, many smaller producers who rely on buyers in the field to perform the service of making royalty payments on their behalf would incur new obligations to calculate payments, fulfill reporting requirements, and deal with audits. They might conclude that Indian leases are not worth the added expense and risk. The added costs and risks imposed by the proposed rule would also likely cause marginal producing wells to be plugged and abandoned, thereby increasing reliance on foreign imports of crude oil. Such increased costs and risks would likely curtail investment in marginal Indian wells, as well as in relatively high risk exploratory wells.

4. The Proposed Transportation Allowances Unfairly Discriminate Against Integrated Lessees

By limiting net-back adjustments for transportation services to certain "actual costs" in many circumstances, integrated companies would be denied the opportunity to recover the price normally charged in arm's-length transactions for those services. Non-integrated competitors, on the other hand, could deduct the full price of transportation services provided by third parties under the proposed rule. The differences between "actual costs" and the full market value of transportation services will vary from place to place, pipeline to pipeline, and company to company.[7] MMS's sole rationale for the distinction is that it "believes that the use of actual costs is fair to lessees and that the use of a FERC-approved tariff overstates allowable costs in non-arm's-length situations." (63 Fed. Reg. at 7094.)

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6 MMS's proposal to take the increase in value off the lease is reminiscent of an attempt by MMS to seek royalties based on the profits attributable to a cogeneration facility located on a lease that used federal lease crude oil. The IBLA rejected this attempt noting that the MMS net-back formula allowed a deduction only for processing costs and failed to account for the fact that the remaining royalty base included profits on the increased value of the oil. *See Petro-Lewis Corp.*, 108 IBLA 20 (1989).

7 Remarkably, efficient companies would tend to be penalized under the proposed rule vis-a-vis less efficient competitors. Other things being equal, an efficient company with lower "actual costs" than their less efficient competitors would have a lower transportation cost adjustment and, thus, would be forced to pay *higher* royalty amounts. Such penalties against efficient companies, and discrimination against integrated companies, is unfair, illogical and unlawful.

Without even considering the shortcomings of the proposed formulae as a basis for valuation, this presumption contradicts well-established Interior Department practice. In *Shell Western E&P, Inc.*, 112 IBLA 394 (1990), for example, the Interior Board of Land Appeals held that it was unlawful for the MMS to deny a tariff-based transportation allowance to a lessee solely on the basis of its affiliated relationship with the transporting pipeline, while at the same time approving a tariff-based allowance for lessees not affiliated with the transporting pipeline. The basis for the Board's decision was that MMS could not discriminate against a lessee that was affiliated with its pipeline transporter, solely based on that affiliate relationship. This very type of discrimination is the central theme of MMS's proposed rule. In short, the discrimination against integrated companies is not only unreasoned, it violates the Department's long-standing practices and clear legal precedent.

III. THE PROPOSED "MAJOR PORTION" VALUATION IS CONTRARY TO THE PLAIN TERMS OF INDIAN LEASES

Starting in 1936, certain standard-form Indian oil and gas leases began to include a so-called "major portion" provision, which generally provides, in pertinent part, that: "During the period of supervision, 'value' for the purposes hereof may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity . . . produced and sold *from the field where the leased lands are situated* . . . ." (*See* Form 5-154h, ¶ 3(c) (Apr. 24, 1936) (emphasis added).) In construing this provision, the IBLA and federal courts have emphasized two key points: (1) the "major portion" must be valued on the basis of prices paid or offered for *oil produced in the same field* as the leased lands; and (2) the lease terms restrict the "highest price" to the price paid (or offered) for the *major portion* of the oil produced and sold from the production field. In *Pawnee v. United States*, for example, the United States Court of Appeals for the Federal Circuit held that MMS did not breach its fiduciary duty to the Indians by failing to "enable them to receive the benefits of gas royalties computed upon the market value determined by the highest price paid or offered for like quality gas at the time of production," because that standard was contrary to the express terms of the Indian leases. 830 F.2d 187, 191 (Fed. Cir. 1987). As the court explained: "The [plaintiffs] demand royalties based on the highest market price or value at the time and/or place of production, but the governing regulation and the leases expressly restrict the highest price 'for the *major portion*' of the gas 'produced and sold from the field where the leased lands are situated.'" 830 F.2d at 191 (emphasis court's). In *Transco Exploration Co. & TXP Operating Co.*, the IBLA rejected as "ludicrous" the lessee's suggestion that "the entire Gulf of Mexico is the relevant area for comparison of prices," because "the language in the regulation requires advertance to the field or area where the leased lands are situated." 110 IBLA 289, 337 n.33 (1989); *accord Supron Energy Corp.*, 46 IBLA 181, 191-92 (1980)("The regulations and lease terms allow the Area Supervisor to consider the actual prices of the gas, etc., sold from the entire field, without regard to the type of market in which the products are sold"). IBLA has also explained how the major portion value should be computed. In *Supron Energy Corp.*, the IBLA upheld the Area

Supervisor's computation of the major portion value on the basis of the median price paid for lease production. The IBLA explained the computation as follows:

> In the instant case, the Area Supervisor assembled complete sales data from all Jicarilla tribal leases for the years 1971 through 1973. He then determined the median price for all gas sold from these leases in each calendar year, that is, the price at which, or above which, half of the gas was sold and, at the same time, the price at which, or below which, the other half was sold. . . . Thus, the figures adopted by the Area Supervisor are based on actual production figures. The Area Supervisor adopted these median prices as the floor values of gas for each year, that is, he held that the "value" of the gas throughout each year was not less than these median values. . . . The median is not necessarily the "highest price paid or offered for the major portion of" the gas. For example, it is possible that the prices offered for the gas were higher than the actual prices paid for it.

46 IBLA at 188.

MMS's proposed "major portion" valuation is contrary to both of these key points, because it would value oil based on prices paid for oil from *other* fields and would base the "major portion" value on the value of the top 25% of the oil sold. The proposed rule seeks to perform the "major portion" calculation using, among other data, downstream, resale prices derived from sales of production from leases in MMS-published "designated areas" that would generally correspond to Indian reservations. Indian reservations are generally much larger in size than a typical oil field. The Navajo Reservation (one of the "designated areas" listed in the proposed rule), for example, contains more than 13 million acres, which is roughly the size of the State of West Virginia. *See Bureau of Competition Report to the Federal Trade Commission on Mineral Leasing on Indian Lands*, at 9 (Oct. 1975). Because the designated areas are not limited to *leases in the same field*, and because the prices reported may be for sales far downstream of the lease, the proposed rule is contrary to the plain terms of the lease agreements. Moreover, the proposed "major portion" calculation would also be derived from the five highest NYMEX futures prices for the prompt month. NYMEX futures prices plainly do not represent the price paid or offered for production from the same field as the lease production. Hence, using NYMEX prices would likewise violate the "major portion" provision of Indian leases.

The proposed use of the 75th percentile price is also contrary to the "major portion" provisions of Indian lease agreements. MMS proposes to "arrange the reported values . . . from highest to lowest" and then choose, as the major portion value, "the value of the 75th percentile (by volume, including volumes taken in kind) starting from the lowest value." (63 Fed. Reg. 7101.) Just as the IBLA explained with respect to the median (50th percentile) value used in *Supron Energy Corp.*, the value of the 75th percentile is "the price at which, or above which, [25% of the oil is] sold and, at the same time, the price at which, or below which, the other [75%] was sold." 46 IBLA at 188. Twenty-five percent is plainly not the "major portion." *See Ladd Petroleum Corp.*, 127 IBLA 163, 173 (1993)(more than 50% is majority); *see also*

Webster's New College Dictionary, 660 (defining "majority" as "a number more than half of the total number of a given group"). While the Indians are correct that the "major portion" need not be *limited* to the median, using the highest price paid for 75% of the oil would require using the *25th* percentile rather than the 75th percentile. In other words, by definition, the 25th percentile is the price at which (or above which) 75% of the oil is sold; the 75th percentile is the price at which (or below which) 25%, not the major portion, of the oil is sold.

IV. THE PROPOSED RULE EXCEEDS THE STATUTORY AUTHORITY OF THE SECRETARY OF THE INTERIOR

The modern authority for mineral leasing of Indian lands comes from the Indian Long-Term Leasing Act, first enacted in 1909, and the Indian Mineral Leasing Act of 1938. The Act of 1909 permits Indian allottees to lease their allotted lands for mining purposes, and authorizes the "Secretary of the Interior to perform any and all acts and make such rules and regulations as may be necessary for the purpose of carrying out the provision of this section into full force and effect." 25 U.S.C. § 396. Similarly, the Indian Mineral Leasing Act of 1938 grants Indian tribes authority, subject to approval of the Secretary, to execute mineral leases for unallotted tribal lands. 25 U.S.C. § 396a *et seq.* The Indian Mineral Development Act of 1982 requires the Secretary to approve leases of Indian lands as part of the Secretary's general trust responsibility for the protection of tribal lands and resources. The Secretary has a duty to oversee Indian leases and ensure that lessees comply with the terms of the leases. *See Jicarilla Apache Tribe v. Supron Energy Corp.*, 479 F. Supp. 536 (D.C. N.M. 1979). Although the Secretary has a fiduciary obligation to the Indians, the Secretary is not the lessor, and cannot grant leases of Indian lands on his own authority. See *Poafpybitty v. Skelly Oil Co.*, 390 U.S. 365, 372 (1968). Nor can the Secretary dictate or alter the lease terms except to deny approval when the lease is determined not to be in the "best interest" of the tribe or Indian allottee. *See* 25 U.S.C. § 2103(b) (requiring Secretary to consider the "best interest" of the Indian tribe when approving or disapproving a lease or similar agreement). Hence, the Secretary's fiduciary role does not give the Secretary any greater rights than the Indians themselves have under the terms of the Indian lease agreements. *See Cotton Petroleum Corp. v. New Mexico*, 490 U.S. 163, 179 (1989)("We thus agree that a purpose of the 1938 Act is to provide Indian tribes with badly needed revenue, but find no evidence for the further proposition that Congress intended to remove all barriers to profit maximization"); *Pawnee v. United States*, 830 F.2d 187, 191-92 (Fed. Cir. 1987)("[T]he fiduciary relationship springs from the statutes and regulations which 'define the contours of the United States' fiduciary responsibilities' [citation omitted]. Where, as in this case, . . . the leases deal directly with the problem and are not challenged, the Indians cannot demand that the United States ignore those provisions or act contrary to them"); *see also* Judith V. Royster, *Equivocal Obligations: The Federal-Tribal Trust Relationship and Conflicts of Interest in the Development of Mineral Resources*, 71 N. Dak. L. Rev. 327, 338 (Feb. 1995)(noting that despite the trust relationship, the Secretary is not a guarantor of tribal profits from mineral leases).

Many of Texaco's Indian leases include a "regulations" provision, which requires the lessee to "abide by and conform to any and all regulations of the Secretary of the Interior, now or hereafter in force relative to such leases, all of which regulations are made a part and condition of this lease . . . ." (*E.g.*, Form 5-154h, ¶ 3(h) (Sep. 1933).) Importantly, however, all of the "regulations" provisions included in Texaco's Indian leases contain an express limitation that no regulations issued after the approval of the lease shall effect a change in the rate of royalty without the written consent of both parties. (*E.g.* Oil and Gas Mineral Lease -- Allotted Indian Lands, ¶ 8 (Mar. 13, 1912)("Provided, however, that no regulations made after the approval of this lease, affecting . . . the rates of royalty or payment thereunder . . . shall operate to affect the terms and conditions of this lease."); Form 5-154h, ¶ 3(g) (Apr. 24, 1936)("Provided, That no regulations hereafter approved shall effect a change in rate of royalty . . . herein specified without the written consent of the parties to this lease"); Form 5-157, ¶ 3(g) (Jun. 1939)(same); Form 5-154h, ¶ 3(g) (Jan. 1962)(same). In construing a similar "regulations" provision included in an Indian uranium lease, the IBLA held that the 1982 amendments to 30 C.F.R. § 231.61 could not be applied to the lease, because the royalty valuation methodology specified in the lease was "intended to be part of the rate of royalty provided by the lease." *Mobil Oil Corp.*, 78 IBLA 107, 111 (1983). Hence, the IBLA concluded, "[s]ince these rates are not subject, under paragraph XVII [of the lease], to future regulation, the 1972 regulations must be examined to determine whether there are applicable rules governing royalty rates outside the lease." *Id.* Consistently, in *United States v. Wichita Industries, Inc.*, the court held that the "regulations" provision precluded use of the "estimated reasonable value" provided for in post-lease regulations, because the lease specified that royalty would be based on a stated percentage of gross proceeds, and was not subject to subsequent regulations that changed the "rate of royalty." 390 F. Supp. 1154 (D.C. Okl. 1974).

Accordingly, although Indian leases are generally subject to the "regulations of the Secretary" they are not subject to any regulations that effectively change the rate of royalty. It is largely for this reason that the Bureau of Competition concluded that modification of the royalty terms in Indian leases was generally "inflexible." *Bureau of Competition Report to the Federal Trade Commission on Mineral Leasing on Indian Lands*, at 80 (Oct. 1975).

A. The Proposed Valuation Methodologies and "Major Portion" Calculation Effectively Increase the Royalty Rate, and Therefore Exceed the Secretary's Statutory Authority

As demonstrated above, neither NYMEX index pricing nor downstream affiliate resale pricing represents value in the producing field, as required by the plain terms of Indian lease agreements. The proposed rule -- by valuing production at a point off the lease, by denying transportation costs from the lease to the boundary of the reservation, and by denying integrated lessees the value of their midstream assets and services -- effectively raises the royalty rate on production from Indian leases, in contravention of the leases' "regulations" provision. Although the royalty percentage remains intact, application of that percentage to a value higher than that intended by the lease is the economic equivalent of raising the royalty rate.

The proposed "major portion" valuation also effectively raises the royalty rate for Indian lease production, because it would be valued based on the higher of the five highest daily NYMEX futures prices and the price paid or offered for the top 25% of production from fields within the MMS-designated area, rather than on the highest price paid for the major portion of production from the same field.

Because the proposed valuation methodologies and "major portion" calculation would effectively increase the royalty rate, the proposed rule is contrary to the "regulations" provision contained in Indian leases. Consequently, the proposed regulations cannot lawfully be applied against any of Texaco's existing Indian leases.

B. MMS Lacks Authority to Apply a Major Portion Value to Indian Lessees Not Subject to Leases with a Major Portion Provision

MMS states in the preamble to the proposed rule that "most Indian leases include a 'major portion' provision." (63 Fed. Reg. 7090.) In fact, many of Texaco's Indian leases do *not* contain a "major portion" provision. As noted above, the "major portion" provision was not added to the standard-form Indian lease agreement until 1936. (*See* Form 5-154h, ¶ 3(c) (Apr. 24, 1936).) Prior to that time, Texaco's Indian leases provided simply for payment of royalties on the basis of the lessee's gross proceeds (*e.g.*, Form 5-154h (Apr. 1, 1914)), or, subsequently, based on the higher of the lessee's gross proceeds and the "posted market price" or "highest posted market price" for oil of like quality in the same field (*e.g.*, Form 1-154h (Sep. 1933)). The proposed rule, however, purports to subject *all* Indian lease production to an MMS-calculated major portion value, whether or not the lease contains a "major portion" provision. Even if the proposed rule were somehow found to be valid as to major portion leases, because application of a major portion value would effectively increase the rate of royalty, the major portion value cannot be applied to leases that do not include a major portion provision.

C. The Secretary Has No Authority to Require Indian Lessees to Transport Lease Production Off the Lease, to the Boundary of the Reservation or Elsewhere, at No Cost to the Lessor

In contrast to the current regulations and the consistent interpretation of Indian lease agreements over the past seventy-five years, the proposed rule would limit transportation allowances to the "actual cost" of moving lease production from the "designated area" boundary to a point of sale or delivery off the designated area, and would no longer permit a transportation allowance for the cost of moving lease production from the lease to the designated area boundary. (63 Fed. Reg. at 7094.) This proposed change, according to MMS, is "based on consistent feedback from Indian lessors that such costs should not be permitted." (*Id.*)

Specifically, the Indian lessors "say that since their leases typically are silent on transportation costs, there is no specific provision permitting such deductions." (*Id.*) However, the Indian lessors "acknowledge that costs to move production away from the reservation/designated area may be legitimate deductions." (*Id.*)

Although Indian leases are "silent on transportation costs," they also *value lease production at the lease*. Implicitly, therefore, if lease production is sold at a point *off the lease*, the lessee is entitled to deduct from the royalty value the costs incurred in moving the lease production to the off-lease point of sale. The IBLA has consistently held that the lessor must bear the costs of transporting and marketing lease production away from the lease. *See Xeno, Inc.*, 134 IBLA 172, 180 (1995)("When gas is valued at a point downstream from the wellhead where the value of production is ordinarily determined, allowances are generally required for the value added to the gas after production"); *Viersen & Cochran*, 134 IBLA 155, 164 (1995)("the Department has long permitted an allowance for certain costs which have been deemed not to be directly related either to the costs of production or to the fulfillment of the lessee's contractual obligation to market production *from the lease*")(emphasis added). The proposed rule, unlike existing Indian leases, would value lease oil at market centers far removed from the production field. It is plainly inconsistent with the lease provisions to both value oil at a point off the lease and refuse to permit an allowance for costs incurred in moving the oil to that point.

Moreover, the selection of Indian reservations as the "designated area" for purpose of the transportation allowance lacks foundation and is clearly arbitrary and capricious. Reservations can vary dramatically in size, ranging from two or three hundred acres to several million acres. *See Bureau of Competition Report to the Federal Trade Commission on Mineral Leasing on Indian Lands*, at 9 (Oct. 1975). A lessee who leases property deep within a large reservation would thus be more harmed by the proposed rule than would a lessee who happened to lease property at the border of a reservation or situated within a small reservation.

D. MMS Has No Authority To Require Indian Lessees To Market Indian Lease Production At No Cost To The Lessor Or At A Location Away From The Lease

The proposed rule wrongfully attempts to require Indian lessees (1) to bear all costs of marketing crude oil, *i.e.*, with the Indian lessors receiving that benefit cost-free, and (2) to bear such marketing duties and costs at locations away from the lease. (*See* 63 Fed. Reg. at 7093-94.) MMS asserts that the proposal would "clarify" the existing regulations, and "is consistent with several Interior Board of Land Appeals decisions construing this duty. *See Walter Oil and Gas Corporation*, 111 IBLA 260 (1989)." (*Id.*) MMS is wrong on both points.

This change is not a "clarification;" it is a major departure from lessee obligations under existing Indian leases and the current regulations. While Indian lessees are currently required by MMS regulations to place crude oil in a "marketable condition" at the lease, they are not required to market the product at no cost to the government, let alone at market centers. "Marketable condition" is defined as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.51 (1996). Once production is in that described physical condition, the lessee's cost-free duty under the lease has been satisfied. Judicial decisions interpreting the "marketable condition" rule have focused on this placement of lease product in the physical condition in which it can be sold; they do not impose an additional duty to market the oil at no cost, which duty MMS attempts to create unilaterally through its proposal. *Mesa Operating Ltd. Partnership v. U.S. DOI*, 931 F.2d 318, 320 (5th Cir. 1991), *cert. denied*, 502 U.S. 1058 (1992); *California Co. v. Udall*, 296 F.2d 384, 387 (D.C. Cir. 1961).

Moreover, the IBLA has not held that Indian lessees have a duty to market lease production at no cost to the lessor or at a location away from the lease. While the IBLA has held that lessees have a duty to market lease production, it has consistently limited that duty to the first available market, because that is the only market relevant to determining the value of the lease production. For example, in *Walter Oil & Gas Corp.*, the IBLA made clear that "the value of the gas for royalty purposes is what a buyer is willing to pay for it." 111 IBLA 260, 264 (1989). Similarly, in *Xeno, Inc.*, the IBLA noted that its decision in *Beartooth Oil & Gas Co.* had been reversed in part because "the Board erred in applying the marketable condition rule without considering the conditions under which gas will be accepted by a purchaser under *a sale contract typical for the field or area*." 134 IBLA 172, 182 n.14 (1995)(emphasis added). Because there is an active crude oil market at the lease, it is the amount purchasers at the lease are willing to pay which determines the value of the crude. Federal court cases are in accord. *See Enron Oil & Gas Co. v. Lujan*, 978 F.2d 212, 215 n.3 (5th Cir. 1992)("the value of a unit of gas is equivalent to what a customer will pay"); *Diamond Shamrock Expl. Co. v. Hodel*, 853 F.2d 1159, 1165 (5th Cir. 1988)("It is obvious from a complete reading of all the relevant statutes, regulations, and lease provisions, that royalties are not due on 'value' or even 'market value' in the abstract, but only on the value of production saved, removed or sold *from the leased property*")(emphasis added); *see also Martin v. Glass*, 571 F. Supp. 1406, 1415 n.2 (N.D. Tex. 1983)("The lessee's obligation to market is to market at the well"). The cases have also consistently held that the lessor must bear the costs of transporting and marketing lease production away from the lease. *See Xeno, Inc.*, 134 IBLA at 180 ("When gas is valued at a point downstream from the wellhead where the value of production is ordinarily determined, allowances are generally required for the value added to the gas after production"); *Viersen & Cochran*, 134 IBLA 155, 164 (1995)("the Department has long permitted an allowance for certain costs which have been deemed not to be directly related either to the costs of production or to the fulfillment of the lessee's contractual obligation to market production *from the lease*")(emphasis added).

Accordingly, because there is an active market at the lease, Indian lessees have no duty to market lease production in a downstream market away from the lease and certainly no duty to market free of cost to the lessor. It follows, therefore, that if MMS chooses to use a downstream resale price to value Indian lease production, it must subtract from that price the full value of downstream assets and services. The proposed rule, on the other hand, seeks to expand dramatically the lessee's duty to market, to require the lessee to market Indian royalty oil for the benefit of, and without cost to, the Indian lessors. The Secretary lacks statutory authority unilaterally to impose such an obligation.

E. The Proposed Record-Keeping and Audit Provisions Exceed the Secretary's Statutory Authority

Proposed section 206.53(a) would require the "lessee" (which would, under the proposed rule, include both the lessee actually designated in the lease and the lessee's affiliates) to make available sales and volume data for production sold, purchased, or obtained from the designated area or from nearby fields or areas, including sales and volume data from private and State leases. Lessees of Indian lands and their "affiliates" would also effectively be required to track Indian lease production through multiple non-arm's-length transactions until the oil is either refined or sold at arm's-length to a nonaffiliated party in order to determine whether the NYMEX-based index price or downstream, "gross proceeds" yields a higher royalty value. Moreover, proposed section 206.52(b) would look beyond arm's-length exchange agreements to effectively require an Indian lessee to track the first arm's-length sale of oil received *in exchange* for Indian lease production. In addition, the proposed rule purports to require anyone who produces, sells, purchases, exchanges, or refines oil produced from Indian lands to complete and file the proposed Form MMS-4416.

Each of these aspects of the proposed rule exceeds the Secretary's statutory authority. Section 103(a) of the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 ("FOGRMA"), which is applicable to both Federal and Indian leases, provides, in pertinent part, that

> A lessee, operator, or other person directly involved in developing, producing, transporting, purchasing, or selling oil or gas subject to this Act through the point of first sale or point of royalty computation, whichever is later, shall establish and maintain any records, make any reports, and provide any information that the Secretary may, by rule, reasonably require for the purposes of implementing this Act or determining compliance with rules or orders under this Act.

30 U.S.C. §1713(a). In construing this provision, the IBLA, as affirmed by the United States District Court for the District of Delaware, and the United States Court of Appeals for the Tenth Circuit have held that MMS can require the production of records from those directly involved in the *first* purchase of Federal oil or gas. *See Santa Fe Energy Products Co. v. McCutcheon*, 90 F.3d 409, 414 (10th Cir. 1996)(concluding that, because lessee's affiliate was a "person directly involved in . . . purchasing . . . oil or gas subject to this chapter through the point of first sale or royalty computation," MMS could require the affiliate to establish and maintain records and make reports); *Shell Oil Co. v. Department of the Interior*, 945 F. Supp. 792, 800 n.7 (D. Del.

1996)("FOGRMA is . . . limited to persons 'directly involved' in transactions of oil or gas from Federal leases"). No case has ever held that MMS can require those who are not directly involved in the first sale of Indian lease production to establish and maintain records or make reports. Nor is there any authority for MMS to require anyone -- lessees or first purchasers -- to establish and maintain records and make reports relating to disposition of non-lease oil *received in exchange* for Indian lease production.

FOGRMA does not limit the term "first sale" to the first *arm's-length* sale between nonaffiliated parties. TEPI's transactions with Equilon, for example, involve *sales* of crude oil, not transfers. Title transfers from TEPI to Equilon, and Equilon pays valuable consideration for the crude oil. Similarly, Equilon's buy/sell transactions with third parties are *sales*. Indeed, MMS's own Oil and Gas Payor Handbook recognizes that exchange agreements and buy/sell transactions are sales. Volume III, Product Valuation, Section 3.3, Oil Exchange Agreements, explains that: "The exchange agreement represents two distinct sales under the contract and the value of lease production is determined at the first point of sale (the first exchange point)."

While MMS may have the authority to impose record-keeping regulations on both parties to the first sale of Indian lease production, it lacks authority to impose any record-keeping or reporting obligation beyond the first sale, or on anyone not directly involved in the first sale (*e.g.*, those who only *refine* oil produced from Indian lands). It follows, therefore, that MMS cannot require lessees to track Indian lease production to its "ultimate disposition." Nor can MMS require Indian lessees, much less their affiliates, to track oil received in exchange for Indian lease production.

V. THE PROPOSED RULE IS NEEDLESSLY COMPLEX AND UNWORKABLE

A. Requiring Indian Lessees to Compute Royalty Value Two Different Ways in Order to Make Multiple "Highest Price" Comparisons Unnecessarily Complicates Royalty Valuation and Increases Costs

The proposed rule would effectively impose a duplicative royalty valuation obligation on Indian lessees. Lessees of Indian lands would be required to compute the royalty value for Indian lease production on the basis of both NYMEX futures settle prices and downstream, gross proceeds. Each of these valuation methodologies is, by itself, far more burdensome and complex than the valuation methodology required under the existing regulations. Moreover, both of the proposed valuation methodologies could create multiple, wholly unpredictable "values" for the same quality crude produced at the same time from the same well.

Arm's-length purchases and sales of crude oil in the field may realize a range of prices that represent market value at the lease. However, because the proposed rule moves valuation off the lease, and ties formula adjustments to such factors as the ultimate disposition of the oil and the status of the lessee, the proposal creates a vast array of unpredictable values beyond the true range of market value at the lease. Wellhead values of crude oil under the proposed rule would be unpredictable, making even short term planning by producers very difficult. The proposed rule requires use of different valuation formulae depending, for example, on whether the crude oil is sold or exchanged, whether the oil received in an exchange is sold or refined, whether the oil is transported to a "market center" or to a refinery, and whether the "designated area" in which the leased land is located includes Cushing, Oklahoma. In addition, within each of these various proposed formulae, the initial computation of royalty value of crude oil would vary depending not only on where the crude oil is moved, but also on how it is moved and how far it is moved. For any given lease, the ultimate destination points and transportation methods and costs for a particular barrel vary widely. Under the proposed rule, crude oil values "at the lease" would be as unpredictable and varied as the number of potential destination points, transportation modes and transportation costs associated with them.

For example, the value of crude oil *in the field* that is moved twenty-five miles from the designated area boundary to a "market center" would be significantly different from the value *in the field* if it were moved fifty miles from the designated area boundary to a refinery. The proposed net-back formulae for each of these destination points would yield wholly different crude oil values in the producing field because the price adjustments would differ for each of these destinations. Such values would have no relationship to actual market prices in the field. In New Mexico, for example, TEPI produces both New Mexico Intermediate and New Mexico Sour crude. On any given day, either of these two crude grades could be commingled in separate pipeline (sweet and sour) common streams. These separate common streams might be transported to a number of disbursed refineries located in at least seven states: (1) New Mexico (Artesia and Lovington); (2) Texas (El Paso, Houston, Beaumont/Pt. Arthur, Longview); (3) Oklahoma (Ardmore, Wynnewood, Ponca City, Tulsa); (4) Kansas (El Dorado, Coffeyville, McPherson); (5) Illinois (Chicago, Wood River, Robinson); (6) Indiana (Whiting, Indianapolis); and (7) Ohio (Toledo, Lima). In addition, barrels sold by co-owners of a single well could have as many different values as there are owners or owner-barrels, without economic or legal justification.

The proposed rule would require lessees to compute royalty value using both the NYMEX-based index pricing and downstream "gross proceeds" methods in order to perform the first "highest price" comparison. Thereafter, the lessee would be required to perform yet another comparison, to determine whether the MMS-published "major portion" value is higher than the royalty value initially reported by the lessee. This proposed duplicative royalty computation and multiple comparison would unnecessarily complicate royalty valuation, increase costs, and reduce certainty with no countervailing benefit (other than to artificially, and unlawfully, inflate the royalty value for Indian lease production).

B. Computation of the Resale "Gross Proceeds" May Be Impossible, Because it is Generally Not Possible to Track the Downstream Disposition of Indian Lease Production or Crude Oil Received in Exchange for Indian Lease Production

Lessees would effectively be required under the proposed rule to determine the ultimate disposition of each barrel of Indian lease production in order to compare the downstream "gross proceeds" to the NYMEX-based index price. For the same reason, Indian lessees would also effectively be required to determine the ultimate disposition of oil received in exchange for Indian lease production.

Once crude oil is commingled there is simply no way to distinguish between Indian and non-Indian oil, or between Indian oil from different leases. Therefore, it is generally not possible actually to trace the ultimate disposition of Indian lease production, or of oil received in exchange for Indian lease production. Rather, some allocation methodology would be required, which, of course, reduces certainty. The proposed rule fails to offer any guidance on what allocation methodologies (*e.g.*, first in first out, last in first out, first in last out, etc.) would be acceptable to MMS. Allocation also presents problems in determining the quality of Indian lease production. For example, if 508 API crude is commingled with 408 crude, there is no accurate way to ascertain how much of the resale price is attributable to which barrels.

To pay correctly royalty on a barrel of oil under the proposed rule, TEPI would need to ascertain the final disposition of every barrel that its affiliates bought, sold, or exchanged during the production month, as well as the methods of transport and the "actual cost" (as defined by the proposed rule) of that transportation. Generally, there is no business reason for Equilon to know from which individual leases its oil comes or to where it goes; it cares only that it has sufficient supply to meet its contracts and that it is making a profit on the activities it performs and risks it incurs. Likewise, Equilon's transportation books, as well as those of the operators on other transportation systems used by Equilon, are not designed to provide the information that would be needed to comply with the proposed rule. Rather, they likely use different depreciation schedules and credit direct and indirect expenses differently from that required under MMS guidelines. However, for TEPI to pay correctly its royalty, it would need to allocate to each barrel of oil each of the various transactions and transportation methods utilized by Equilon. The matrix that would be required to compute the necessary allocations is mind-boggling and absolutely inappropriate and unnecessary. And, if anything changes, it would be necessary to recalculate the entire matrix. As well, the entire computation would be subject to revision if the "major portion" value computed by MMS proved higher than the royalty value computed on the basis of the "initial" highest price comparison.

Far from streamlining or adding certainty to the valuation of Indian lease production, the proposed rule is needlessly complex and unworkable. Administration of the proposed valuation regulation would also require many, many more MMS auditors. The proposed rule is thus completely antithetical to the Administration's goal of streamlining government.

VI. THE PROPOSED RULE WOULD IMPOSE AN ENORMOUS ADMINISTRATIVE BURDEN ON INDIAN LESSEES WITH NO COUNTERVAILING BENEFIT

A. The Cost of Compliance Would Increase Dramatically Under the Proposed Rule

The proposed rule would dramatically increase the cost of compliance. The proposed rule would result in increased cost to attempt to trace Indian lease production to the first, downstream "arm's-length" sale. Computer systems would need to be changed to capture sales and exchange data, calculate prices, and perform recalculations whenever any component of the price changes. The proposed rule would also result in increased cost to collect information necessary to pay royalties on NYMEX-based index prices. Computer systems would be necessary to develop prices and retain information on an historical basis in order to make prior period adjustments. Existing computerized revenue systems would likely require modification to accommodate the dual pricing methodologies. The proposed changes in allowable transportation deductions would also result in reduced deductions and increased costs.

In addition, the proposed rule would result in a dramatically increased audit burden on both MMS and industry. Tracing affiliate resale proceeds, calculating permitted allowances and adjustments, and determining the appropriate index prices would make future audits significantly more complicated. Industry would be faced with increased record-keeping requirements in order to document all of the components of the weighted average price calculations for affiliate sales.

B. Completion of the Form MMS-2014 Would Become Extraordinarily Burdensome and Costly

The current Form MMS-2014 generally assumes that there will be one type of disposition and valuation methodology for any one lease. The form does not report the information that would be required for Indian lessees to compute royalty value under the proposed rule, much less to perform the multiple comparisons that would be required. Accurate royalty valuation under the proposed rule would require tracking every transaction, and all of the transportation costs, for every barrel of Indian lease production from the lease through the first arm's-length sale. Computation of transportation costs would also be far more burdensome under the proposed rule, because it requires tracing lease production downstream of the lease. By contrast, the current regulations require computation of transportation costs only to the first collection point.

The supplementary proposed rule would therefore require changes to the MMS-2014 to capture the information needed to compute the royalty valuation and perform the required multiple comparisons. Reporting systems that currently create MMS-2014s for electronic filing would have to be reprogrammed.

Because Indian lease production may have many different royalty valuations under the supplementary proposed rule, Texaco would have to establish different divisions of interest for almost every barrel. Because Texaco's computer system allows only two prices for each pipeline division property ("PLDP") number, it would be necessary to establish many more PLDP entries to account separately for different portions of the lease production. As well, the proposed rule might, because of its complexity, virtually destroy the single payor concept. Few parties would agree to be the designated Payor under such an onerous system.

As pointed out in the Barents Group analysis submitted in response to MMS's request for extension of its existing collection authority for the Form MMS-2014, MMS has ignored completely the substantial increase in time and record-keeping that would be required to complete the Form MMS-2014 if the supplementary proposed rule for Federal oil valuation is implemented. MMS's request for extension of its collection authority similarly ignores the additional burden that would be imposed by this proposed rule. Lessees do not currently know or retain the information that would be required to compute royalty valuation required under the proposed rule.

If, for example, crude oil is transferred in two non-arm's-length transactions before being disposed of through an arm's-length sale, to complete MMS-2014, the lessee would first have to obtain the sales price from the party that sold the oil at arm's-length. Assuming that the lessee was able to obtain the sales price from the ultimate seller (and this is something that is uncertain), it must then trace through each transaction from arm's-length sale to the first non-arm's-length transfer keeping track of any appropriate location and quality differentials and "actual" transportation costs. Lessees may not have access to the "actual" transportation cost information that would be needed to comply with the proposed rule. These transportation adjustments must be reported separately on the MMS-2014. Because the crude may have been commingled with other production from either Indian or non-Indian leases, some allocation method would be required. If some of the lease production is ultimately refined rather than sold arm's-length, completion of the MMS-2014 becomes even more complicated and time-consuming.

C. The Proposed Form MMS-4116 Would be Highly Costly and Largely Useless

In complying with the requirements of proposed Form 4416, a midstream affiliate must have access to information such as MMS lease numbers, lease locations, production rates, gravity at the lease, and sulfur that would generally reside with an upstream production affiliate. Conversely, an upstream affiliate filling out the form would need to develop information on pricing and other contractual terms that resides with midstream affiliates. Integration of information systems between TEPI and Equilon to capture accounting information necessary to complete Form 4416 would be very costly. We understand that the Office of Management and Budget rejected the initially-proposed Form 4415 for a variety of reasons; The proposed Form 4416 is equally flawed.

MMS provides no support for its assumptions underlying the estimated costs associated with the new proposed form. For example, MMS assumes that it would take 30 minutes on average per filing and $35 per hour of labor effort. From Texaco's viewpoint, the MMS estimate is far too low and its assumptions are invalid. MMS fails to account for the practical difficulties in obtaining the required information, which does not currently exist. Texaco, for example, does not normally compute "actual transportation costs" of its midstream operations within the meaning of 30 C.F.R. § 206.55, and has no independent business reason for doing so. Such calculations would require substantial changes in Equilon's accounting system. MMS's implicit assumption that all of the information required to fill out Form 4416 is readily available and systematically maintained by lessees in the normal course of business is completely inaccurate as applied to Texaco. A procedure and data system would have to be developed to gather, analyze, and record this data. Within Texaco, the lessee/payor, *e.g.*, TEPI, generally does not engage in buy/sell or exchange transactions. Rather, TEPI's customer, Equilon, engages in such transactions. No practical means exists to link information relating to midstream operations with production information for a specific lease. Crude oil produced from specific leases is almost invariably commingled with other production before reaching a destination point. The financial systems of Equilon would have to be linked with the royalty reporting systems of TEPI; midstream systems would have to be modified to interface with upstream systems; and pricing systems would have to be modified to interface with aggregation systems. Such modifications would require a major investment in system design and programming time. Even if it were somehow possible to begin submitting information on Form 4416 in the proposed two month period, which we seriously doubt, the compliance effort would cause a serious economic dislocation within TEPI and Equilon.

We also disagree with hourly labor cost assumed by MMS. Texaco would need to assign experienced analysts and train additional personnel to collect and report crude oil transportation and other costs in the context of exchange and buy/sell arrangements. The average salary, with benefits and overhead, of an appropriately experienced professional employed by Texaco would be substantially higher than the $35 per hour MMS estimate.

Much of the information required on Form 4416 would be useless. Although MMS purports to use the data for assessing location/quality differentials between designated areas and associated "market centers," MMS would require Texaco to fill out forms involving transactions having nothing to do with such differentials. Any given volume of crude oil flowing from a lease can be the subject of numerous buy/sell or exchange agreements either between market centers or prior to reaching any market center. Such irrelevant information is proposed to be collected not only for Indian lease production but for private and State leases as well.

It is instructive to consider, for example, how Form 4416 data would affect the valuation of Wyoming crudes. The proposed NYMEX index formula would be used to value crudes as diverse as Wyoming Asphalt. Wyoming Asphalt is valued based on factors of supply and demand relating to requirements principally for road pavers and roofing product manufacturers. Pipeline constraints are a substantial, and dynamic, factor in pricing Wyoming Asphalt crude. In the unlikely event that meaningful data from Form 4416 could be used to compare Wyoming Asphalt to West Texas Intermediate ("WTI"), such data would not be current. For example, had data been collected in 1996 from proposed Form 4416 for Wyoming crudes, factors such as the opening of the Express Pipeline in April 1997, delivering Canadian crude oil to Casper with subsequent delivery to the Salt Lake refining area, would have been ignored. Canadian crude movements on this pipeline have recently had a significant impact on the value of many Wyoming crude grades. Yet such logistical factors would not be reflected on any prior year's Form 4416 data. Although this is a dramatic example of a changing logistical condition, many more subtle, non-obvious conditions can impact location/quality differentials at any given time. The MMS proposal suggests that lessees could file for equitable relief when such conditions change. Yet conditions can change as rapidly as the weather. The ensuing requests for administrative adjustments would create a virtual flood of filings and resulting chaos for MMS and royalty payors.[8]

Moreover, the published differentials, between the "designated areas" and five associated "market centers" would be largely useless. In addition to the fact that the information would be obsolete before it is published, the proposed market centers bear little or no relationship to the actual disposition of Indian crude.

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8 For the record, we wish to refer MMS to a March 27, 1997 report submitted in comments on the proposed rule for valuation of Federal oil by Barents Group, LLC, entitled "Preliminary Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value For Royalty Due On Federal Leases And On Sales Of Federal Royalty Oil." The report was based in part on a study of Texaco's operations and the burden that would be imposed by the proposed Form MMS-4415 (which, except for the title and introductory data, is virtually identical to the proposed Form MMS-4416). The Barents' report concluded that "[m]ost of the information that would be collected on the proposed Form MMS-4415 will not be usable for MMS's intended purpose of estimating 'location/quality differentials' between 'market centers' and 'aggregation points.'" (Barents Report at p. iv.) In addition to finding huge, unnecessary administrative costs that would be imposed on both the private sector and MMS by the proposed reporting requirements, Barents found that the proposal would "yield no benefits in terms of its objective of developing more reliable estimates of the market value of the oil produced from federal lands." (*Id.*) Because the proposed Form 4416 is substantially the same as the initially proposed Form 4415, Barents' observations are equally applicable to the proposed Form 4416.

VII. MMS HAS FAILED TO CONSIDER LESS BURDENSOME AND MORE RELIABLE ALTERNATIVES, SUCH AS TENDERING AND TAKING INDIAN ROYALTY IN KIND

A. Texaco's Tendering Program is a Far Less Burdensome and Much More Reliable Benchmark for Royalty Valuation than Either the Resale or NYMEX Pricing Alternatives Proposed by MMS

Texaco's tendering program is a far less burdensome and much more reliable benchmark for royalty valuation at the lease than the royalty valuation methodologies contained in the proposed rule. MMS, however, has failed to consider using a tendering program. At the public hearing in Denver, Colorado, MMS admitted, in response to a question from a Texaco representative, that no thought had been given to a tendering program. (Transcript of Hearing in Denver, Co., Apr. 1, 1998, at 12-13.)

Beginning in August 1995, TEPI developed a tendering pilot program to track market value at the lease. Following a successful test in the Offshore Louisiana Gulf, TEPI implemented tendering throughout the United States, including California. A tender is an invitation to bid to third parties to purchase crude oil at the lease. TEPI's tendering methodology is based on bidding out representative volumes of crude oil in order to value similarly situated crude oil that is not sold arm's-length. Under TEPI's current tendering program, the first step is to categorize the marketing areas into areas of comparable crude oil quality. Marketing areas are determined on the basis of type of oil (*e.g.*, sweet or sour) and transportation (*e.g.*, truck, barge, or pipeline) and are further categorized based on costs to common transportation points. The marketing areas generally correspond to specific geographic areas.

Currently, the volume of oil tendered ranges from approximately 12.5% to 20% of the volume available from a specified marketing area. Generally, the percentage tendered is at least equivalent to the royalty share of the oil.[9] The tendered volumes do not come proportionally from each lease or from all leases in the marketing area, but instead are packaged so that significant quantities are available at a marketing area to attract competitive bids.

Bids are solicited through letters sent to all credit-worthy buyers known to be active purchasers in a particular area. Most of the bidders are producers, refiners, or marketers. TEPI's affiliates are not allowed to submit bids under the tendering program, because it was felt that affiliate participation might discourage some bidders. The bid invitations specify individual leases, volumes, and transportation methods. Sales are made at the lease. The purchaser is

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9 Although the current TEPI tendering program requires tendering an amount at least as great as the royalty share, TEPI has found that tendering at least 10% of the production is sufficient accurately to establish the market value.

responsible for transportation downstream from the lease. Bids are for a six-month term, which is fairly standard in industry practice. The bids are evaluated when they are received, and the highest bidder is awarded the tender volume. Texaco has a small staff to direct the tendering effort and uses Equilon Enterprises, L.L.C., a recently-formed joint venture between Texaco Inc. and Shell Oil Company, as its agent for certain administrative purposes of the tender.[10]

Equilon has the opportunity to purchase the remaining production volumes at the high bid price. Equilon routinely exercises this option. On occasion, TEPI has determined that the highest bid is insufficient. In such situations, TEPI negotiates with Equilon the market price. On other occasions, Equilon has determined that the highest bid price is overvalued and has declined to purchase the remaining untendered volumes. If this occurs, TEPI offers these volumes to the high bidder. If the high bidder does not purchase all of the remaining volumes at the original high bid price, those volumes remaining are retendered.

TEPI pays royalty on the basis of the proceeds received from production tendered to third parties. For production sold to Equilon, the third party transactions are "normalized" to establish the price of affiliate sales. Normalization is the process by which TEPI utilizes the tendered price to adjust, if necessary, values of oil not sold to third parties within the marketing area. Adjustments are based primarily on location differences and certain quality differences. Adjustments generally are not made for gravity, because the bid request requires the crude to be deemed. In the normalization process, TEPI uses certain known "market reference points" in adjusting for location. Leases with a common crude oil delivery station generally will have the same price. The process can also result in a higher or lower price for volumes not actually tendered depending on the distance from the lease to the common delivery point. Because these tender packages are designed to aggregate representative volumes of comparable crude, there is very little impact on the high bid price from normalization.

TEPI's tendering program is intended to establish the most accurate value possible at the lease, taking into consideration all relevant economic factors. It clearly provides a proper means for valuing production for royalty purposes, since the value assigned to the production reflects the price received in actual arm's-length transactions at the lease in the relevant marketing area. In short, it is market-based and market-driven. This is particularly important because each marketing area has unique characteristics. By tendering an amount at least as great as the royalty share, TEPI ensures that a volume significantly large enough to determine market price has been used.

A tendering program of the type employed by TEPI should be permissive for Indian lessees. Although tendering is clearly effective in setting a fair value for crude in the producing

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[10] Texaco Trading and Transportation, Inc., a wholly-owned subsidiary of Texaco Inc., performed these services before Equilon. Accordingly, TEPI's experience with tendering is based on its experience with TTTI.

field, not every company would be capable of implementing an effective tendering program. Tendering may also be unsuited for certain small leases or leases that require trucking the lease production off-site.

TEPI's tendering program has worked extremely well to achieve market value prices at the lease level. We strongly urge that those companies willing and able to sell a representative share of production be accorded the full recognition that a fair royalty value is established by these arm's-length sales at the lease. TEPI would be willing to consider tendering Indian royalty volumes at the lease.

TEPI currently has more experience with tendering than any other Indian or Federal lessee. With appropriate protection for our proprietary information, we would be pleased to meet with MMS to explain our tendering program in greater detail and to assist in developing guidelines for adaptation of the program for all Indian lessees.

B. The Least Burdensome and Most Reliable Alternative Would be for the Indian Lessors to Take Their Royalty in Kind

If MMS and the Indian lessors are unwilling to adopt a tendering program like that employed by Texaco, they should take the Indian royalty in kind. RIK has, for example, been successfully used in Canada. Taking Indian royalty oil in kind would allow the Indian lessors to obtain fair market value for their oil without the unnecessary administrative complexity and burden that would be imposed by the proposed rule. Unlike the proposed rule, the RIK alternative would ensure that the Indian lessors obtain the market value of their oil at the lease, rather than improperly inflating the Indian royalty share by the additional value added by downstream assets and marketing services. Furthermore, the RIK alternative would not impose any burdensome record-keeping requirements on Indian lessees, much less their affiliates. Rather, like the current royalty valuation regulations, taking royalty in kind would retain the lessee's obligation to put Indian oil in marketable condition, but would not impose an obligation on the lessee to market the production at no cost to the Indian lessors.

Despite the obvious advantages of the RIK alternative, MMS has failed to consider using it to value Indian oil.

VIII. THE PROPOSED RULE DOES NOT PROVIDE AN ADEQUATE BASIS FOR PUBLICATION OF EITHER AN INTERIM OR FINAL RULE

A. MMS Has Failed to Provide the Requisite Notice and Opportunity for Comment

The preamble to the proposed rule explains that: "In addition to comments received on the Advance Notice of Proposed Rulemaking, MMS attended a number of presentations by:

crude oil brokers and refiners, commercial oil price reporting services, companies that market oil directly, and private consultants knowledgeable in crude oil marketing. MMS deliberations were aided greatly by a wide range of expert advice." (63 Fed. Reg. at 7090.) However. the proposed rule fails to identify the experts and consultants upon whom MMS relied or to describe the presentations that these individuals and others made.

Moreover, MMS has not been forthcoming in response to numerous Freedom of Information Act requests for the information necessary to analyze properly the proposed rule, and has not provided sufficient time to analyze the conclusory information that was provided. As a result, MMS has failed to give interested parties such as Texaco adequate notice and an opportunity to comment as required by the Administrative Procedure Act. *See Home Box Office, Inc. v. Federal Communications Comm'n*, 567 F.2d 9, 35 (D.C. Cir.)("the notice required by the APA, or information subsequently supplied to the public, must disclose in detail the thinking that has animated the form of a proposed rule and the data upon which that rule is based"), *cert. denied*, 434 U.S. 829, *reh'g denied*, 434 U.S. 988 (1977); *Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973)("It is not consonant with the purpose of a rule-making proceeding to promulgate rules on the basis of inadequate data, or on data that . . . is known only to the agency").

B. The Proposed Rule Fails to Provide a Sufficient Statement of Basis and Purpose or Explain Why MMS is Changing Settled Principles of Royalty Valuation

In promulgating new royalty valuation regulations, MMS is required by the Administrative Procedure Act to provide a "concise general statement of basis and purpose." 5 U.S.C. § 553(c). This "basis and purpose" statement is required in order to facilitate meaningful judicial review, by demonstrating to a reviewing court the legal and factual support for the agency's action. *See Mobil Oil Corp. v. Department of Energy*, 728 F.2d 1477, 1496 (Temp. Emer. Ct. App. 1983), *cert. denied*, 467 U.S. 1255 (1984). Moreover, an agency's notice must "provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully." *Chemical Waste Management, Inc. v. Environmental Protection Agency*, 976 F.2d 2, 28 (D.C. Cir. 1992)(citing *Florida Power & Light Co. v. United States*, 846 F.2d 761, 765 (D.C. Cir. 1988), *cert. denied*, 490 U.S. 1045 (1989)).

The proposed rule fails to provide an adequate basis or reasoned explanation for rejecting use of arm's-length sales prices in the production field. It would be arbitrary and capricious for MMS to change the existing regulations without providing an adequate basis or explanation. *See Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 52 (1983) (holding that an "agency must explain the evidence which is available, and must offer a 'rational connection between the facts found and the choice made'").

The proposed rule also fails to articulate any factual basis for its conclusion that arm's-length transaction prices are no longer valid indicators of value. Indeed, the comments accompanying the proposed rule make clear that MMS began its analysis with the preconceived view that prices in the production field would not be used. The sole justification provided in the proposed rule is the unsupported premise that crude values in the field "could be" hidden in certain exchange agreements and that arm's-length sales prices "may" be suspect simply because companies deal with each other:

> MMS proposes this multiple comparison largely because of concerns that current oil marketing practices *may* at least partially mask the actual value accruing to the lessee. Multiple sales and purchases between the same participants, while apparently at arm's-length, *may* be suspect concerning the contractual price terms.

(63 Fed. Reg. at 7091 (emphasis added).) A rulemaking should be based on fact, not suspicion.

Indeed, by ignoring the market at the lease, the proposed rule utterly fails to meet the "most important" criteria stated for alternative proposals, because it does not "reflect 'highest price paid or offered at the time of production for the major portion of oil production *from the same field*.'"(63 Fed. Reg. at 7093 (emphasis added).)

In similar circumstances, the Supreme Court has rejected an administrative record based on supposition as a basis for a new regulation:

> Recognizing that policymaking in a complex society must account for uncertainty, however, does not imply that it is sufficient for an agency to merely recite the terms "substantial uncertainty" as a justification for its actions. As previously noted, the agency must explain the evidence which is available, and must offer a "rational connection between the facts found and the choice made." . . . Generally, one aspect of that explanation would be a justification for rescinding the regulation before engaging in a search for further evidence.

Motor Vehicle Mfrs. Ass'n., 463 U.S. at 52 (citation omitted). The administrative record here provides *no evidence* that the existing crude oil valuation regulations are not working or should be rescinded.

The purpose of a comment period is to allow interested parties "to communicate information, concerns, and criticisms to the agency during the rulemaking process." *Connecticut Light & Power Co. v. NRC,* 673 F.2d 525, 530 (D.C. Cir. 1982), *cert. denied*, 459 U.S. 835 (1982). An agency has an especially high duty to disclose technical studies and data:

> In order to allow for useful criticism, it is especially important for the agency to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules. . . . An agency commits serious

> procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary.

Id. at 530-31; *accord, Lloyd Noland Hosp. & Clinic v. Heckler*, 762 F.2d 1561, 1565 (11th Cir. 1985) ("The original notice cited only a 'study conducted by a HEW consultant.'"); *Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 392 (D.C. Cir. 1973) (rejecting rulemaking based on testing identified only as having been "conducted by the Environmental Protection Agency and/or contractors": "[w]e find a critical defect in the decision-making process in arriving at the standard under review in the initial inability of petitioners to obtain -- in timely fashion -- the test results and procedures used on existing plants which formed a partial basis for the emission control level adopted, and in the subsequent seeming refusal of the agency to respond to what seem to be legitimate problems with the methodology of these tests."), *cert. denied*, 417 U.S. 921 (1974).

Again, Texaco is unable to discern any evidence in the public record supporting the conclusions of MMS's consultants, which form the basis of the proposed rule.

C. MMS Has Failed to Consider Comments Received in Response to the Proposed Rule for Valuation of Federal Lease Production

Despite the similarity between the proposed rule and the rule proposed in January 1997 for valuation of Federal oil,[11] and notwithstanding the fact that the same office was responsible for drafting both proposed rules, MMS has largely ignored comments received in response to the proposed rule for valuation of Federal lease production.

As the United States Supreme Court held in *Motor Vehicle Manufacturers Ass'n*, "[a]n agency rule would be arbitrary and capricious if the agency . . . offered an explanation for its decision that runs counter to the evidence before the agency." 463 U.S. at 43. The Court in that case also held that an agency acts arbitrarily and capriciously if it fails to consider suggested alternatives or to provide a reasonable explanation of its decision to reject an alternative. MMS's failure to consider comments received in response to the proposed rule for valuation of Federal lease production, while at the same time relying on unidentified, unexplained sources, is not only arbitrary and capricious, but wastes the time and resources of those who in good faith commented on the earlier proposal.

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[11] MMS has publicly commented on the similarity between the two proposed rules: "The Indian Rule as it exists today is tied directly to the Federal Rule with one exception . . ." (Transcript of MMS Hearing in Albuquerque, N.M., Mar. 26, 1998, at 5); "In a nutshell, the current Indian rule is tied directly to the federal rule" (Transcript of MMS Hearing in Denver, Co., Apr. 1, 1998, at 4).

Accordingly, to ensure that the administrative record includes the comments received in response to the rulemaking for Federal oil valuation, we hereby incorporate the public comments filed by Texaco and others in response to the Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases (62 Fed. Reg. 3742), Notice of Reopening the Public Comment Period (62 Fed. Reg. 46460), and the Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases (63 Fed. Reg. 6112).

D. MMS Has Not Complied with Executive Order 12630

Executive Order 12630 requires MMS and other executive departments and agencies to "review their actions carefully to prevent unnecessary takings" and to "account in decision-making for those takings that are necessitated by statutory mandate." 53 Fed. Reg. 8859 (1988). Specifically, the Executive Order requires MMS to "identify the takings implications" of the proposed rule and "address the merits of [the proposed rule] in light of the identified takings implications." *Id.* at 8862. The underlying purpose of the Executive Order is to ensure "[r]esponsible fiscal management and fundamental principles of good government" by requiring "government decision-makers [to] evaluate carefully the effect of their administrative, regulatory, and legislative actions on constitutionally protected property rights." *Id.* at 8859.

MMS did not comply with Executive Order 12630, based on its certification that "the rule does not represent a governmental action capable of interference with constitutionally protected property rights." (63 Fed. Reg. at 7098.) Given the fact that the proposed rule is contrary to the express provisions of existing Indian oil and gas leases and flies in the face of seventy-five years of settled law and contract-backed expectations, MMS's certification is erroneous and unjustified. Accordingly, MMS should comply with the requirements of Executive Order 12630.

E. MMS Has Not Complied With Executive Order 12866

The Office of Management and Budget has determined that the proposed rule is a "significant regulatory action" within the meaning of Section 3(f)(4) of Executive Order 12866. That section provides that a "'[s]ignificant regulatory action' means any regulatory action that is likely to result in a rule that may . . . [r]aise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order." 58 Fed. Reg. 51735, 51738 (1993). However, MMS concluded that the proposed rule would not have a significant *economic* effect, as defined by Section 3(f)(1) of the Executive Order. (63 Fed. Reg. at 7098.) The Executive Order defines a "[s]ignificant regulatory action" as one that is likely to result in a rule that may:

> (1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; *or*

(4) Raise novel legal or policy issues . . . .

58 Fed. Reg. at 51738.

Because the criteria are listed with the disjunctive "or," meeting *any* one of the four criteria is sufficient to render the proposed rule a "significant regulatory action," which triggers the requirement that a cost/benefit analysis be conducted. Yet, it does not appear that MMS has conducted any cost/benefit analysis required by Executive Order 12866. In particular, MMS has not conducted an assessment of the costs and benefits of potentially effective and reasonably feasible alternatives. Nor has MMS made available any evidence that would support such a cost-benefit analysis.

F. MMS Has Not Complied With the Paperwork Reduction Act

The Paperwork Reduction Act, 44 U.S.C. § 3506 (1994), requires each federal agency to reduce information collection burdens on the public and to increase information program efficiency. 44 U.S.C. § 3506(b)(1)(A), (b)(1)(B). Proposed Form 4416 would achieve the opposite result. It would substantially increase the information collection burden on the public, and greatly decrease the efficiency of the royalty management program. MMS estimates that Form 4416 would create an additional annual reporting burden of 1,313 hours, requiring each royalty payor to examine each of its crude oil exchange and sales contracts and to compile location differential information therefrom. As explained above, this estimate is a gross understatement of the burden that would be imposed on royalty payors.

MMS submitted its Form 4416 proposal to the Office of Management and Budget for review under Section 3507(d) of the Act. (63 Fed. Reg. at 7098.) Pursuant to Section 3506(c)(3), MMS was required to certify that the information requirement would be implemented in a manner consistent so much as possible with the existing reporting and record-keeping practices of those who are to respond. 44 U.S.C. ß 3506(c)(3)(B),(E). Again, as explained above, the proposal would require Indian royalty payors to compile information in an entirely new fashion, which would be extremely burdensome and costly to achieve. In sum, the Form 4416 proposal violates the Paperwork Reduction Act.

In addition, MMS has failed to compute or report to the Office of Management and Budget the added record-keeping burden that would be imposed on Indian lessees in filing the existing MMS-2014.

IX. CONCLUSION

Texaco urges MMS to withdraw the "Proposed Rule for Establishing Oil Value for Royalty Due on Indian Leases" because it unfairly and unlawfully attempts to boost government revenues by improperly valuing crude oil for royalty purposes and adding increased value to crude oil after it leaves the lease. We urge MMS to give serious consideration to more accurate and less burdensome measures of Indian lease production, including Texaco's tendering program and taking Indian oil in kind. The proposal is based on fundamentally false assumptions about crude oil markets and blatantly discriminates against integrated firms. We hope to assist MMS in any effort to clarify or improve methods to ascertain values of crude oil at the lease. We believe that such methods must continue to use arm's-length sales prices at the lease as a matter of fairness, practicality and law.

Sincerely,

James C. Pruitt

James C. Pruitt

Attachments:

1) Report of Dr. Philip K. Verleger, Jr.
2) Report of Dr. Benjamin Klein
3) Report of Samuel A. Van Vactor
4) Report of Robert B. Bossung
5) Excerpts, Testimony of Benjamin Johnson
6) Excerpts, Testimony of Dr. Joseph P. Kalt